ANNUAL TRADE PROJECTION REPORT TO CONGRESS

Prepared Jointly by the Department of the Treasury
and the Office of the United States Trade Representative

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ANNUAL TRADE PROJECTION REPORT - 1991

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PART I: INTRODUCTION

The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) contains numerous reporting requirements, including, in Section 1641, a requirement for an Annual Trade Projection Report.

The report is to include: a review and analysis of key economic developments in countries and groups of countries that are major trading partners of the United States; projections for developments in various macroeconomic variables in the reporting year and the following year; conclusions and recommendations for policy changes to improve the outlook; and, a discussion of the impact on U.S. trade of market barriers and other unfair practices.

The legislation specifies that the report is to be prepared jointly by the Treasury Department and the Office of the United States Trade Representative, in consultation with the Chairman of the Board of Governors of the Federal Reserve System. The report is to be submitted on March 1 of each year to the Senate Finance Committee and the Ways and Means Committee of the House of Representatives.

Part II of this report reviews recent macroeconomic developments in countries or groups of countries that are major trading partners of the United States, as well as key recent developments in the U.S. economy. Part III presents projections for main macroeconomic variables in 1991 and 1992 for the same countries and country groups. These two parts are organized as follows: Section 1 discusses economic growth, trade and current account developments, and policy trends in the industrial countries; Section 2 discusses developments elsewhere in the global economy. Part IV reviews policy issues raised by these projections. Part V discusses the impact on U.S. trade of market barriers and other unfair practices. Parts I-IV were prepared by the Treasury Department; Part V was prepared by the Office of the Trade Representative.

Readers are, in addition, referred to the Treasury Department's semi-annual Report to Congress on International Economic and Exchange Rate Policy, which discusses key issues, including exchange rate developments, in considerable depth and provides a more detailed review of important recent historical trends. That report is also prepared pursuant to the Omnibus Trade and Competitiveness Act of 1988.

PART II: REVIEW AND ANALYSIS OF DEVELOPMENTS IN 1990

1. Industrial Countries

The macroeconomic performance of the major industrial countries in 1990 reflected a number of largely anticipated underlying trends as well as unanticipated developments arising in large part from the Persian Gulf crisis.

The slowdown in the overall pace of economic growth that was widely forecast for the second half of the year proved sharper than expected due in large part to heightened consumer/investor uncertainties and higher oil prices. Growth trends in the individual economies continued to diverge significantly, with strong growth persisting only in Japan and Germany, while the United States, U.K. and Canada slipped into recession by year-end. Measured inflation rates appear to have peaked in the middle/late part of the year for many countries, despite the oil price spike and other transitory developments, and underlying trends indicated a modest improvement in the "core" inflation picture toward year-end. The external adjustment process continued as further declines were recorded in the largest trade and current account imbalances.

A. U.S. Economic Performance

Latest available data confirm a pronounced slowdown in U.S. GNP growth in 1990, extending the steady loss of momentum underway since the first quarter of 1988. On an annual average basis, GNP rose 1.0 percent in real terms in 1990, after growth of 2.5 percent in 1989 and 4.4 percent in 1988. The slowdown was evident in each of the major national accounts line items except government consumption, which accelerated only slightly. As was the case in 1989, export growth was by far the strongest individual component (continuing to exceed real import growth by a large margin), and personal consumption growth the weakest. Total domestic demand grew more slowly than overall GNP (0.5 percent on average), extending an important trend that has been underway since 1987. Thus, improving net exports continued to make a positive contribution to growth.

Consumer prices rose 5.4 percent in 1990 after an increase of 4.8 percent in 1989. Excluding the more volatile food, shelter and energy components, consumer prices rose at an annual average rate of 4.9 percent in 1990 versus 4.4 percent in 1989. (Energy prices rose 8.3 percent on average and 18.1 percent on a December-to-December basis.) The broader, fixed weight GNP deflator rose only marginally to 4.6 percent (from 4.5 percent in 1989) though there was a pickup in measured price pressure during the second half.

On the external side, the merchandise trade deficit narrowed $6.2 billion to $108.7 billion, while the current account deficit narrowed $10.7 billion to $99.3 billion. On the national accounts basis, the deficit on net exports of good and services declined $20.3 billion in real terms, to $33.8 billion.

The improvement in the U.S. external position on the balance of payments basis derived from a decrease in the merchandise trade deficit, an increase in the surplus on services, and a shift to a surplus on investment income. The trade deficit in 1990 was equivalent to just under 2 percent of GNP, versus 3.5 percent of GNP when the deficit was at its nominal peak ($159.5 billion) in 1987. The current account deficit was equivalent to 1.8 percent of GNP last year versus 3.6 percent of GNP ($162.3 billion) in 1987.

The national accounts allow us to look at this movement in real terms. On this basis real net imports of goods and services fell to the equivalent of about 0.8 percent of GNP in 1990, a major improvement relative to its peak level of 3.5 percent of GNP in 1986. Since the 1986 peak, the deficit on net exports has declined about $96 billion. This shift on the external side has had a significant positive impact on overall U.S. GNP performance in recent years, accounting for approximately 21 percent of total U.S. GNP growth since 1986, and about 50 percent in 1990.

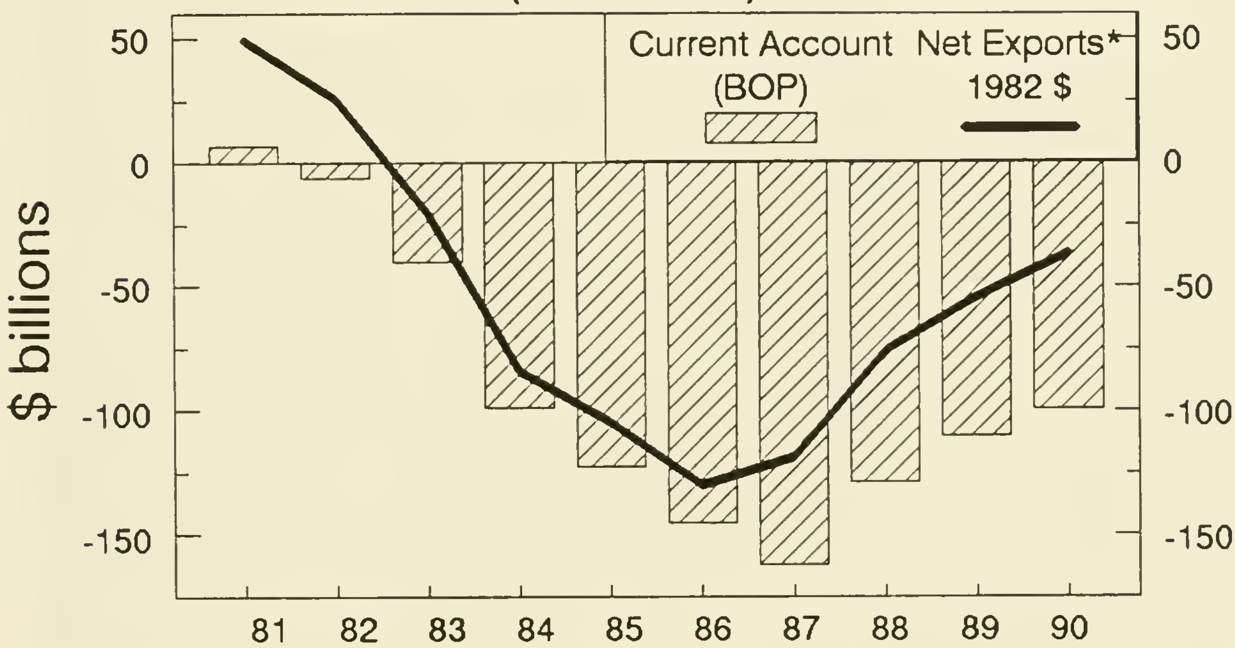
The external correction in 1990 reflected the continued relative strength of U.S. exports. Merchandise exports rose 8.8 percent, or $28.8 billion in value terms, in 1990 on the balance of payments basis; merchandise imports increased 5 percent, or $22.6 billion. In real terms (i.e., in 1982 prices), national accounts data indicate a 6.4 percent increase in goods and services exports in 1990 versus a 2.8 percent increase in imports. This continues the roughly 2:1 growth rate differential that has been observed since 1986.

External account trends on both the balance of payments basis and the national accounts basis are presented in the chart on the following page. Substantial progress has clearly been made by both measures, though the price-adjusted NIPA aggregate shows considerably more adjustment since 1986.

The reason for the discrepancy lies with differences in the behavior of export and import prices in recent years. Import price increases have exceeded export price increases (roughly 6 percent per year versus about 4 percent) since 1986, which tends to inflate the nominal value of imports relative to exports and therefore diminish the decline in the nominal deficit. (For example, the total bill for petroleum imports rose $11.2 billion, or 22 percent, in 1990 reflecting a 20 percent price increase but only a 1.3 percent volume increase.) When these price effects

are filtered out, the underlying volume trends may be seen more clearly; and it is these developments which relate most directly to real variables such as output and employment.

U.S. External Account Trends
($ billions)



* Net exports of goods and services on a national accounts basis

A number of important trends in U.S. bilateral and regional merchandise trade imbalances continued in 1990: the aggregate U.S. deficit with other industrialized countries improved further, as did the deficit with the Newly Industrialized Asian economies (NIEs); but the deficit with OPEC members widened.

The U.S. balance with the 12 European Community member countries continued to improve, registering its first surplus ($4.9 billion) since 1982. Since its peak deficit of $22.3 billion in 1986 the U.S. balance with the EC has improved $27.2 billion. Surpluses with the U.K. and the Benelux countries continued to increase, and the bilateral balance with France moved slightly into surplus. However, the U.S. bilateral deficit with Germany widened moderately (to $9.7 billion) due to a rebound in U.S. imports; U.S. exports to Germany continued to grow solidly.

ALTERNATE MEASURES OF EXTERNAL ACCOUNT TRENDS

External account developments may be gauged by two different measures, the balance of payments and the national income and product accounts. Used together, they can provide a comprehensive view of external developments, as well as insights into the important role that can be played by relative price developments.

The national income and product accounts (NIPA) presentation of the foreign sector differs from the more traditionally used balance of payments presentation largely because of different treatment of a number of international transactions. In the case of the United States, the most important difference is in the treatment of interest paid to foreigners on their holdings of U.S. government securities. These flows are included in the balance of payments reckoning (as part of the current account) but are excluded from the NIPA measure. In addition, the two measures give different treatment to capital gains and losses on direct investment flows and to all transactions between the United States and its territories and Puerto Rico. Finally, the NIPA presentation is most familiar in its real, or price-adjusted, form (1982 dollars for the United States), while balance of payments aggregates are always shown as current nominal values.

A particular attribute of the NIPA measurement is that by separating the domestic side of the economy (essentially private and public consumption and investment) from the external side (exports and imports of goods and services), it clearly identifies the relative contribution of each to the overall growth performance. In addition, current value NIPA aggregates may be adjusted with import and export price deflators to uncover underlying volume developments in goods and services flows. The resulting real aggregates are important in gauging the impact of external sector trends on output and employment. The balance of payments measure, on the other hand, provides the most comprehensive and internationally comparable picture of international transactions and is therefore more useful in analyzing developments in the context of financial market trends and global payment patterns.

The U.S. bilateral trade imbalance with Japan declined almost $8 billion further in 1990, albeit to a still high level of $41.8 billion. Total adjustment since the deficit peak in

1987 has been $15.1 billion. U.S. imports from Japan declined in 1990 for the first time since 1975 while U.S. exports continued to grow. Exports to Canada grew moderately, but slightly outpaced import growth, narrowing the U.S. bilateral deficit slightly to $9.4 billion. (Canada is by far the largest U.S. trading partner, with inward and outward flows accounting for nearly 20 percent of total U.S. trade.)

The U.S. deficit with OPEC rose to $24.8 billion, its highest level since 1981. As noted above, price developments were largely responsible for the increase. Since 1988, the U.S. trade deficit with OPEC has risen $15.5 billion, offsetting nearly half of the overall U.S. deficit reduction achieved with the rest of the world during the past two years and thus contributing importantly to the observed slowdown in the overall rate of trade deficit reduction.

The U.S. trade deficit with the non-OPEC member developing countries remained essentially unchanged at $39.4 billion. Bilateral deficits declined against each of the four Asian NIEs, bringing the combined deficit with the NIEs to $21 billion; deficit reduction against these countries has totaled nearly $14 billion. Despite reduced U.S. deficits with Mexico (the third largest U.S. trading partner) and Brazil, the U.S. deficit with other countries in the Western Hemisphere (excluding Canada) widened by about $1.5 billion to $10.1 billion.

A number of developments in the commodity composition of trade flows in 1990 are worth noting. Exports of non-automotive capital goods rose 11 percent (nominal terms, balance of payments basis) while such imports increased just under 4 percent. Consumer durables exports grew 20 percent while imports grew less than 1 percent, though the net U.S. deficit remained large ($33 billion). Exports of automotive products rose 5.5 percent while imports were essentially unchanged; however, the deficit also remains large (about $20 billion) in this sector.

B. Economic Developments in Other Industrial Countries

I. Growth Trends

Real GNP growth in the foreign industrialized countries (OECD members excluding the United States) continued to decelerate in 1990, slipping from 3.7 percent to 3.3 percent.

Japan was again the major country growth leader in 1990, as real GNP growth accelerated to 5.6 percent, from 4.7 percent in 1989. Domestic demand growth remained steady at 5.8 percent (vs. 5.7 percent in 1989). Thus, the growth gap between GNP and domestic demand has narrowed from 1.4 percentage points in 1988 to 1.0 percentage points in 1989 and 0.2 percentage points in

1990. Private consumption spending again advanced nearly 4.5 percent, balancing the competing influences of solid income gains and a late-year, Gulf war-related deterioration in consumer confidence. Rebounds in public and residential investment outlays offset a modest easing in business investment, keeping overall investment growth quite strong. On the external side, import and export growth rates (real terms; NIPA basis) both slowed substantially; import growth continued to exceed export growth, but by a smaller margin (12.5 percent vs. 10.7 percent) than in any year since 1987.

GNP growth in the **four largest European countries** slowed by about one-half of a percentage point, as did domestic demand growth. However, the divergences in the growth performances of the individual countries that had begun to emerge in 1989 widened further in 1990. Specifically, growth accelerated in Germany but slowed in France, Italy and the U.K.

Germany saw GNP growth strengthen from 3.8 percent in 1989 to an estimated 4.5 percent last year. Domestic demand growth accelerated even more sharply, from 2.7 percent to 4.6 percent. With real disposable income benefitting from higher wages, stable inflation, and a substantial tax cut, private consumption growth rose to its highest level in two decades (approximately 4.5 percent). Investment spending also accelerated, as unification-related demand bolstered both the equipment and construction sectors. On the foreign trade side, goods and services imports grew to meet the higher domestic demand while softer conditions in key markets slowed export growth somewhat. Nevertheless, external developments had a small net positive effect on German GNP in 1990. (Note: These data apply to western Germany only. GNP data for eastern Germany -- formerly the GDR -- have not been published by the German government.)

Growth slowed further in the **United Kingdom** in 1990, with pronounced weakness emerging during the second half of the year. Real GNP growth slipped to an annual average rate of 0.6 percent. Domestic demand growth fell by 0.3 percent as private consumption expenditures rose less than 2 percent and fixed investment outlays contracted by about 1.5 percent. However, the external picture improved substantially relative to 1989. Export growth picked up a bit to just under 5 percent, while import growth fell to less than 3 percent in the face of weak domestic demand; as a result, the foreign trade sector exerted a net expansionary effect on the U.K. economy in 1990.

France also experienced weaker growth in 1990, though the economy remains on a path of continued moderate expansion. Capital investment activity slowed, as did stock accumulation; private consumption held generally firm, although surveys suggested diminished consumer confidence toward year-end. On the

external side, the rate of export growth was halved (to just under 5 percent) and lagged the rate of import growth by about one percentage point. In **Italy** real GNP remained on a path of continued, but appreciably weaker, growth; industrial production contracted in the second half and was slightly negative for the year. Investment activity lost steam -- as did household consumption and exports -- but all nonetheless remained on a positive track. As elsewhere, consumer and business surveys indicate a downturn in confidence during the second half.

The situation in **Canada** is similar to that of the U.K. in that it, too, is experiencing an anticipated adjustment to the excessive demand pressures that emerged in 1988. Private consumption growth remained positive in 1990, but much weaker, and fixed investment spending contracted; export growth picked up and import growth slowed. Overall, real GNP advanced 0.9 percent in 1990 (after 3.0 in 1989) and domestic demand growth dropped from 4.2 percent to zero.

The **smaller OECD countries** also turned in a generally weaker performance in 1990. Weighted average GNP growth in these countries (essentially the rest of Europe, plus Australia and New Zealand) slipped from about 3.8 percent in 1989 to an estimated 2.8 percent in 1990. As in the larger countries, domestic demand growth slowed more sharply, especially in Australia and New Zealand. In particular, investment activity cooled in most of the smaller economies after several years of unusual strength.

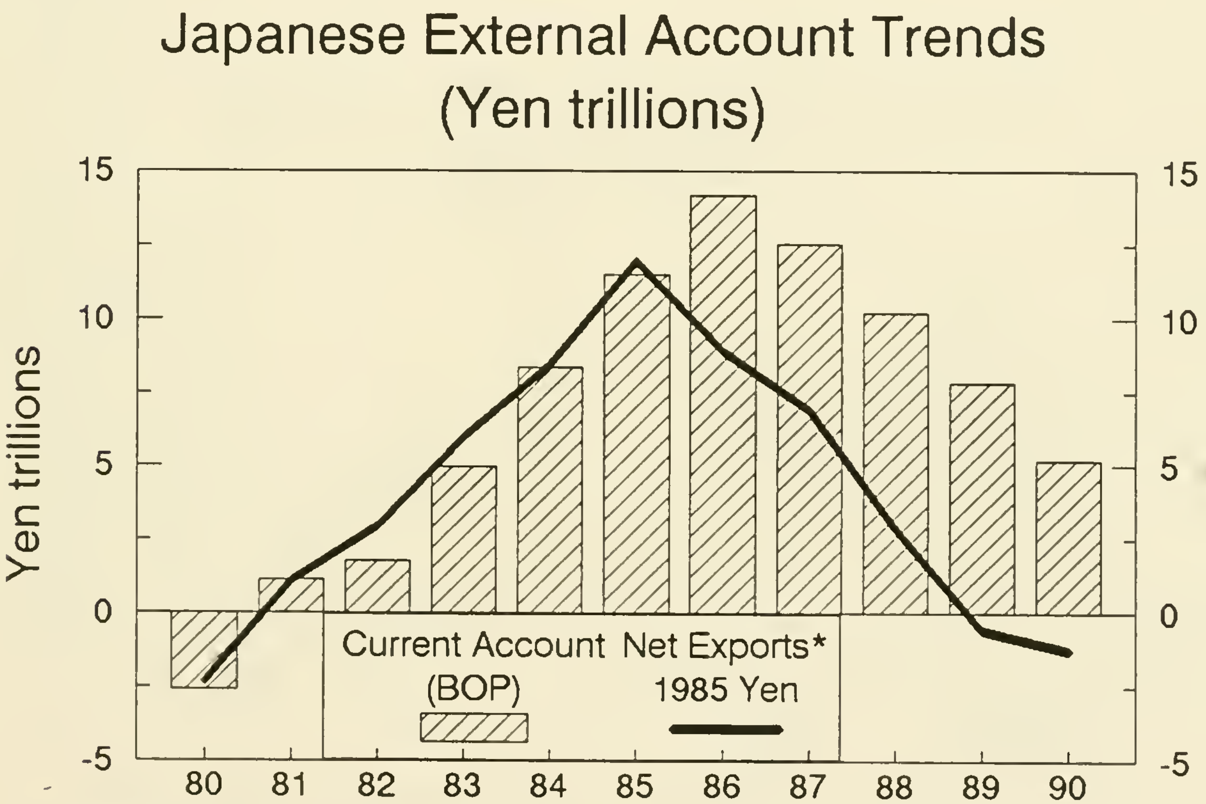
II. Trade and Current Account Developments

Additional progress was made in 1990 in reducing the largest trade and current account imbalances outside the United States (i.e., those of Japan, Germany and the U.K.). Numerous other OECD countries experienced moderate deteriorations in their external positions due in the main to the unanticipated oil price surge during the second half of the year.

Japan's current account surplus declined substantially again in 1990, falling $21 billion to $35.8 billion. The 1990 correction followed a $22 billion decline in 1989, and brought to $51 billion the total decline in the Japanese surplus since its peak in 1987. In terms of GNP, the current account surplus declined over the same period from 3.6 percent to the equivalent of 1.2 percent last year. The trade surplus declined an additional $14 billion in 1990 (to $64 billion, or 2.2 percent of GNP), bringing the total correction to about $32 billion since the 1987 peak. The invisibles deficit rose $19 billion over the same period.

Several factors contributed to the additional Japanese external adjustment in 1990. The growth of import volume (census basis) continued to exceed (though only marginally) that of exports, as has been the case since 1986. Secondly, the terms of trade moved against Japan again in 1990, due in part to the increase in oil prices: import unit values rose by 10.2 percent while export unit values rose 3.4 percent. Thus, volume changes aside, price changes alone would have boosted the import bill and reduced the surplus. In the invisibles account, higher deficits on travel, transportation, and transfers contributed to a $8.3 billion deficit increase.

The external adjustment process in Japan mirrors that of the United States in one important respect: the nominal balance of payments data do not fully express the amount of underlying (i.e., price-adjusted) adjustment that has occurred. The chart below illustrates the differences.

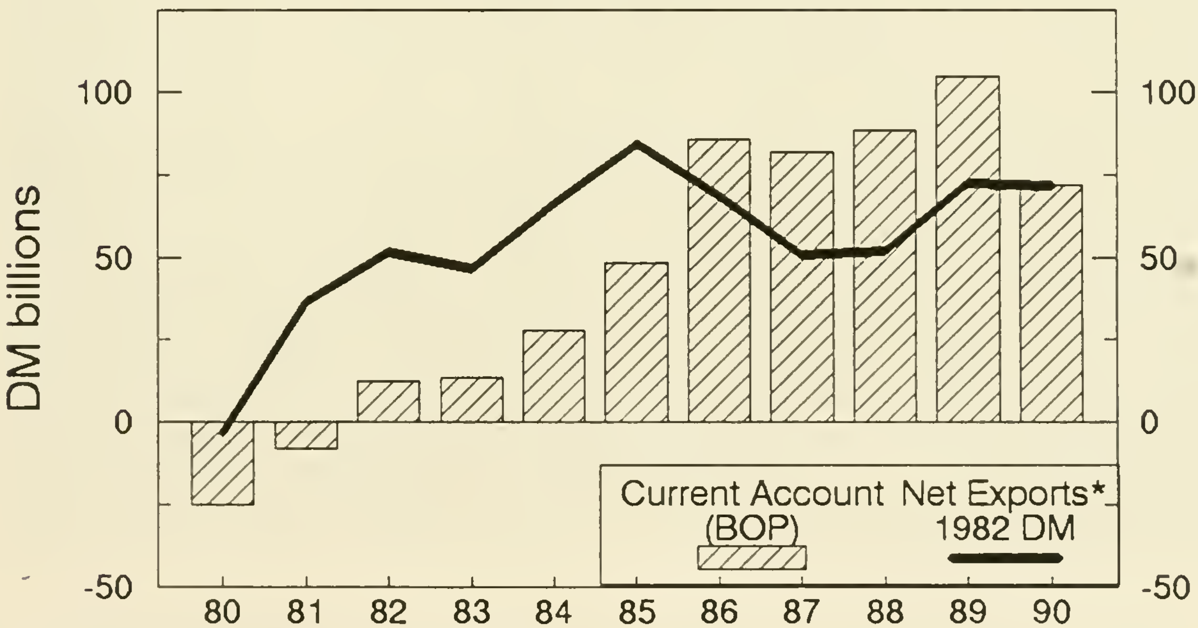


* Net exports of goods and services on a national accounts basis

In dollar terms, the Japanese current account surplus declined by about 60 percent between 1987 and 1990. However, on a price-adjusted national accounts basis the degree of adjustment has been larger. In volume terms, Japanese imports of goods and services increased 45 percent between 1986 and 1990 while export volume simultaneously rose about 14 percent.

German trade and current account surpluses declined substantially in 1990; in the case of the current account, this was the first time the surplus failed to increase in over a decade. In dollar terms the current account surplus declined almost $11 billion (19.5 percent) to $44.5 billion; the trade surplus declined $6.4 billion (9 percent) to $65 billion. Given the appreciation of the deutschemark against the dollar the correction was larger in DM terms: 31 percent and 12 percent, respectively. The correction on both the trade and current accounts was significant as a percent of GNP, though by this measure both remain quite large. (The trade surplus dropped from 6.3 to 4.4 percent of GNP; the current account surplus from 4.6 percent to 2.5 percent.)

German External Account Trends
(DM billions)



* Net exports of goods and services
on a national accounts basis

The pronounced strengthening of domestic demand boosted import absorption significantly; volume rose nearly 11 percent in 1990 (balance of payments basis) after 7.7 percent in 1989. Export volume growth, on the other hand, was limited to 2 percent by slower demand growth abroad as well as by higher domestic absorption of goods that might otherwise have been exported. The picture on the national accounts basis in 1990 also reflected the external adjustment that was underway. Growth of goods and services exports slowed to about 9.6 percent in real terms while real import growth accelerated to 11.5 percent.

GERMAN EXTERNAL STATISTICS

Unification has necessitated some major presentational changes in Germany's foreign trade statistics and posed some challenges in interpreting the new data. Since the division of Germany, balance of payments data for the Federal Republic (FRG) did not include commerce with the German Democratic Republic (GDR), reflecting the fact that the GDR was not considered a separate country. Commerce with the GDR was accounted for in an entirely separate set of statistics. (The external line items in the FRG national accounts, in contrast, included commerce between the FRG and the GDR.) Since July 1990, however, the German government has published all-German balance of payments data, i.e., including the former GDR. (GNP and inflation data continue to cover western Germany only.)

These data will need to be treated carefully for some time given the lack of direct comparability with earlier data and the major structural changes that are underway in Germany. For example, there has been a large shift in the import sourcing of former GDR firms from traditional suppliers in the USSR and Eastern Europe, which counted as imports in the external accounts of the former GDR, to FRG suppliers, which is now treated as internal commerce. Similarly, there has been a jump in the amount of merchandise being imported into the FRG (counted as traditional imports) for "re-export" to the former GDR, which is not counted as foreign trade.

The deterioration in the trade and current accounts of the **United Kingdom** that had been underway for a number of years was reversed in 1990. The current account deficit eased back considerably from its 1989 peak of $31.3 billion to $22.8 billion; the trade deficit was reduced from $39 billion in 1989

to $31 billion last year. Both nevertheless remain fairly large in proportion to GNP: the trade deficit was equivalent to 3.4 percent of GNP; the current account deficit was 2.4 percent. The U.K.'s external correction in 1990 reflected several factors: the sharp cooldown in domestic demand (and imports); continued improved performance on the export side; and, a large increase in net direct investment earnings.

While the four largest external imbalances narrowed in 1990, developments in the **other major industrial countries** were mixed. In **France** the trade deficit widened moderately to about $9.5 billion reflecting higher oil import costs and some loss of

external competitiveness due to the effective appreciation of the franc. **Italy's** trade deficit narrowed slightly due in part to an exchange rate related decline in import prices, while the current account deficit widened to about $12 billion due mainly to negative developments on the tourism account. **Canada's** trade surplus widened to about $9 billion reflecting both a modest export recovery and much weaker import growth; the current account deficit remained substantial, at $13.7 billion or 2.4 percent of GNP.

III. Macroeconomic Policy Developments

The growing divergence among the cyclical positions of the major countries combined with the heightened uncertainty arising from the outbreak of the Persian Gulf crisis to create a more challenging environment for economic policy makers. The main priorities remained achievement of sustained growth over the medium-term, low inflation, and consolidation of the public sector finances.

The monetary authorities in the industrial countries continued to focus primarily on trying to balance judgments about the prospects for inflation, on the one hand, against judgments about the cyclical position and underlying strength of the national economies on the other. As a general matter, the monetary authorities have continued the cautious approach they have pursued in recent years, with the reduction of inflation expectations being given particular emphasis.

The principal medium-term objective of fiscal policy remains to strengthen budgetary positions in order to increase national saving and complement monetary policies aimed at price stability. As a general matter, greater efforts have been made in recent years to limit the growth of public expenditures and to improve the efficiency of tax regimes. Nevertheless, budgetary developments in individual countries continue to be strongly affected by the impact of cyclical trends, as well as (in the case of Germany) unanticipated structural changes.

Japan's fiscal position strengthened further in 1990, with the general government budget surplus (including the equivalent of federal, state and local budgets) increasing to an estimated 2.8 percent of GNP. Revenue growth has been boosted by continued strong economic activity while expenditures have been restrained in the context of a long-standing commitment to reduce public borrowing. Monetary policy was maintained on the cautious side in 1990 reflecting the continued economic strength and concern about the potential inflationary implications of oil prices and wage negotiations; the Bank of Japan raised the discount rate twice during the year, from 4.25 percent to 6 percent.

Unification has dramatically changed the fiscal situation in **Germany**. After recording a small general government budget surplus in 1989 (0.2 percent of GNP), the overall public sector account (including the former GDR) moved sharply into deficit in 1990 (2.3 percent of GNP). Net public sector borrowing rose to an estimated 3.1 percent of GNP in 1990. The shift reflects the impact of both unanticipated expenditures associated with unification as well as the final stage of Germany's multi-year tax reform program. Introduction of German Economic and Monetary Union in mid-1990 (including the conversion of Ost Marks to Deutschemarks) makes it difficult to interpret trends in the monetary aggregates. Nevertheless, the Bundesbank's policy orientation was one of caution in the face of the perceived inflation potential of unification; the discount rate was raised from 6 to 6.5 percent in early 1991 and market interest rates rose appreciably at both the long and short ends.

The **French** authorities continued to pursue a policy of monetary restraint in order to preserve French export competitiveness against the background of the existing exchange rate parities within the European Monetary System's Exchange Rate Mechanism (ERM). Fiscal policy remained cautious and, on balance, mildly contractionary. In **Italy**, a trend toward lower interest rates persisted until the latter part of the year when a return to higher rates became necessary to preserve the lira's ERM parities. On the fiscal side, the authorities remained on a course of slow consolidation in an effort to continue to slow the rise in the burden of public debt and reduce a central government deficit that now stands at about 11 percent of GNP.

The **United Kingdom's** commitment to monetary restraint was given added impetus by its October 1990 entry into the ERM, and by the priority this accords to reducing substantially the U.K.'s relatively high inflation rate. The central government budget surplus remained broadly unchanged in 1990 (as a percent of GNP) as the government persisted with its program of medium-term fiscal restraint in support of its basic inflation objectives. Monetary conditions remained generally tight in **Canada** as well, reflecting concern about the potential inflation implications of

several years of robust domestic demand growth. Fiscal policy continues to be formulated in the context of a medium-term effort to reduce the relatively large public sector deficit.

2. Economic Trends Outside the Industrial Countries

The economic performance of the developing countries (LDCs) generally deteriorated in 1990 and regional disparities widened relative to 1989. Real GNP growth (weighted average) slipped to just below 1 percent from an estimated 3.1 percent in 1989 reflecting the industrial country slowdown as well as the structural shifts underway in Eastern Europe and the unsettled situation in the Middle East. The median inflation rate moved up slightly to about 10 percent, though rates in a handful of individual countries were extremely high. The combined LDC current account deficit rose marginally: the fuel exporting countries moved into surplus for the first time since 1985 while the non-fuel exporters experienced a higher deficit.

The LDC growth slowdown in 1990 reflected reduced growth in each of the major geographic regions. **Asian** economy growth slipped slightly to about 5 percent but was still by far the best regional performance. A rebound of Korean growth helped maintain aggregate growth in the four Asian NIEs at about 6-1/2 percent, despite weaker expansion in Taiwan. The **African** economies continued to expand, though at a more moderate 2 percent estimated pace; the sub-Saharan economies maintained positive, but weaker, GNP growth but experienced a further decline on a per capita basis.

The European, Middle Eastern and Latin American LDCs contracted on average in 1990, particularly those with debt servicing difficulties. Despite the benefits accruing to some oil producing countries, economic activity in the **Middle East** region was strongly affected by the commercial and financial disruption of the Iraqi invasion of Kuwait. Most of **Latin America** was adversely affected by deteriorating terms of trade, although the oil producing countries were net beneficiaries. Mexico turned in its second consecutive year of real growth in the 3 percent range, and the Venezuelan economy rebounded strongly from its deep recession of 1989. In other cases, such as Brazil, transitional weakness in 1990 reflected in part the implementation of stabilization policies designed to address long-standing underlying economic imbalances.

The overall inflation picture in the LDCs continued to be seriously skewed by very high recorded rates in a relatively few larger economies. On a GNP weighted average basis, LDC inflation is estimated to have remained near its 1989 level of about 105 percent. **Latin American and European LDCs** continue to have the most serious inflation problems, as was the case during the

entire decade of the 1980s. Argentina and Brazil both had annual average consumer price inflation in the range of 2,500 percent in 1990, though in both cases a deceleration was emerging by year end. In **Eastern Europe**, price reforms, a large monetary overhang, and higher oil prices produced a surge in measured inflation rates in some countries.

However, the inflation picture was less striking elsewhere. As noted above, the median LDC inflation rate is estimated to have been closer to about 10 percent in 1990, or little changed from 1989. Indeed, preliminary estimates suggest that weighted inflation rates may have declined somewhat in Africa, Asia, and the Middle East in 1990.

The overall current account position of the LDCs changed relatively little in 1990, with their aggregate deficit increasing from $21 billion to about $27 billion. However, some substantial regional divergences emerged, largely reflecting developments in commodity markets, especially for oil. The major oil exporters moved from rough balance in 1989 to a surplus of about $15 billion as export volumes and prices rose.

Meanwhile, the combined current account deficit of the non-oil LDCs increased, mainly reflecting a deterioration in their terms of trade (import price increases in excess of export price increases) and weaker demand growth in key export markets. The aggregate surplus of the four **Asian NIE**s declined for the third consecutive year, to about half of the $30 billion peak surplus recorded in 1987. (Of the approximately $6 billion decline in the NIEs' trade surplus in 1990, about $4 billion was accounted for by the group's declining bilateral surplus with the United States.) **Eastern Europe**'s trade deficit widened in 1990 as a result of higher oil bills and import growth; thus, higher net transfer receipts notwithstanding, the region's current account moved into a small deficit.

PART III: PROJECTED DEVELOPMENTS IN 1991 and 1992

The global economic expansion underway since 1983 is forecast to continue this year -- albeit at a slower pace than in 1990 -- and to gain renewed strength in 1992. As usual, the global trend will mainly reflect developments in the industrial countries, where aggregate real GNP growth of around 1 percent in 1991 is expected to pick up to the 2-1/2 to 3 percent range in 1992. The LDCs are expected to record modestly improved growth this year (just under 1 percent) and return to about a 3-1/2 percent rate in 1992. Consumer price inflation in the industrial countries this year should ease slightly from 1990's 5 percent rate and then drop back to the 4 percent range in 1992. Average inflation in the LDCs is forecast to decline substantially in 1991 and 1992 as rates are brought down in Eastern Europe and Latin America.

World trade growth (in real terms) should continue to run at its historical rate of just over twice the pace of output growth, or 2-1/2 percent in 1991 and around 5-1/2 percent in 1992. Thus, international trade will remain an important source of stimulus and support for output growth. The continued cyclical divergences among the major economies should support some further current account adjustment this year, particularly in terms of GNP. With these divergences expected to narrow in 1992, however, some renewed widening in key current account imbalances cannot be ruled out.

Projections for Foreign Industrial Economies

A. Economic Growth

Economic expansion is expected to continue, albeit at a slower aggregate pace, in industrial countries outside of the United States in 1991 and to regain some of its momentum in 1992. The major cyclical divergences which emerged clearly in 1990 are forecast to persist this year but then narrow significantly in 1992. Specifically, the current recession in the U.K. and Canada should give way to recovery later this year and in 1992 while the rapid growth rates observed in Japan and Germany in 1990 give way to a more moderate pace this year and next.

There are likely to be some significant shifts in the composition of growth in the industrial countries this year and next. Weak (or negative) private consumption growth in the recessionary economies in 1991 is expected to pull the industrial country average to well below rates recorded during the expansion to date. This applies as well to private investment growth, which for the past several years has been a principal source of dynamism in the industrial economies. As recovery takes hold in the English-speaking countries in 1992, however, the overall picture is likely to "normalize," with private consumption and

investment rates trending back toward a level more consistent with historical experience.

International trade activity should continue to track closely with industrial country output trends. Trade volume growth is therefore forecast to slow somewhat further this year but then pick up again in 1992. Given the technical assumption of stable oil prices and exchange rates, current account developments should be driven mainly by cyclical trends and the shifts in competitiveness that have already been observed. Thus, the relatively weak economies should see reduced external deficits this year, as should Germany given its special circumstances. The expected return to a more uniform growth pattern in the major economies in 1992, however, suggests that substantially less adjustment may be in prospect; indeed, a lull in the foreign adjustment process, or even a reversal in some cases, cannot be ruled out.

Japanese growth is forecast to slow this year but should nevertheless remain the highest among the Summit countries. Consumer spending will probably ease relative to 1990, but will continue to get support from high employment and wage growth, as well as a post-war improvement in confidence. Investment spending is likely to slow substantially in 1991, the product of a squeeze on profits, higher capital costs, and several years of very strong investment activity. These trends, coupled with continued restraint on public sector spending growth, will pull domestic demand off its recent 6 percent growth path, though it should continue to outstrip GNP growth by a small margin. GNP prospects for 1992 would appear to be broadly similar, with private consumption and investment maintaining growth rates in about the ranges likely to be observed this year. Over the two year 1991-92 period, therefore, annual GNP growth in the 3-1/2 to 4 percent range is anticipated.

Prospects for the **German** economy are more uncertain than at any time during the past decade, with the still insufficiently understood costs and effects of unification being felt throughout the economy. Nevertheless, with the passage of some of the special growth-boosting factors at play in the domestic economy last year, German GNP expansion is likely to slow during the course of the next 7 quarters. Private consumption growth is expected to be contained by the absence of the stimulus of last year's tax cut, the new tax increases to finance unification, and the generally heightened level of uncertainty among households. Plant and equipment investment growth is also likely to ease after two consecutive years of impressive strength, though unification-related construction demand (both residential and business) will provide continued support. Overall GNP growth averaging about 2-1/2 percent this year and next can realistically be anticipated.

Indications thus far suggest that 1991 will be an important transition year for both the **U.K.** and **Canada**. Both economies finished 1990 on a contractionary note, and while some renewed growth momentum should develop over the next few quarters, latest IMF projections suggest that GNP growth for 1991 as a whole could be moderately negative. Domestic demand growth is likely to be weaker than GNP as high interest rates and strained profit positions will continue to put pressure on investment spending while household budget consolidation (and a tax increase in Canada) limits private consumption to only minimal growth. The recovery forecast for the latter part of this year is expected to gain some strength in 1992. Contributing factors should be a return to positive investment growth (aided by a more supportive inflation/monetary environment) and some rebound of consumer spending (partly reflecting improved sentiment).

The **other industrial countries** (including France and Italy) are expected to follow a pattern of slower growth in 1991 giving way to renewed, though moderate, strengthening in 1992. Most of these economies entered 1991 with a significant loss of momentum in both consumption and investment growth, reflecting the slowdown in the English-speaking countries, the effects of high real interest rates, and the uncertainty generated by the Persian Gulf crisis and the oil price spike. Consumer and business confidence fell sharply throughout **continental Europe** during the second half of 1990, and made itself felt in weaker order books and employment data.

However, the restoration of growth in the recessionary economies during the course of this year, coupled with an improved outlook in the wake of the Persian Gulf war, should support stronger growth during the latter part of this year and into 1992. The overall pattern of private consumption and fixed investment is thus likely to be a dip to a lower rate of growth this year followed by a rebound in 1992. An average real GNP growth rate of about 2 percent in 1991 should be followed in 1992 by a return to roughly last year's 2-1/2 percent rate.

B. External Account Developments

The general pattern of major country growth forecast for 1991 -- relatively strong growth in the main surplus countries and relatively weak growth in the deficit countries -- should support further reductions in the largest trade and current account imbalances.

In **Japan**, export volume growth is expected to slow further this year reflecting demand weakness in key foreign markets. However, Japanese import absorption is also likely to slow due to

CURRENT ACCOUNT SITUATION IN PERSPECTIVE

The net current account surplus of the six foreign Summit countries (i.e., excluding the United States) has been reduced from $123 billion in 1986 to an estimated $22 billion in 1990. Divergences in individual country imbalances measured as a percent of GNP have also been sharply reduced. In 1986 the United States had a current account deficit equivalent to 3.4 percent of GNP; at the same time, Germany had a surplus of 4.4 percent and Japan a surplus of 4.3 percent. By last year the U.S. deficit had been cut to about 1.8 percent of GNP, while the Japanese and German surpluses were reduced to 1.2 and 2.9 percent of GNP, respectively.

the less robust pace of domestic demand, and the technical assumption of relative stability for oil prices will eliminate a very important reason for last year's higher import bill. These factors are expected to limit the scope for further trade surplus reduction in 1991, even though in volume terms the expansion of imports will continue to exceed that of exports. Any correction that does emerge may therefore be relatively small (especially compared to the large adjustment observed last year), and a modest increase in the Japanese trade surplus cannot be ruled out. The current account, moreover, will remain strongly influenced by the rising deficit on the invisibles account (services and transfers). In particular, Japanese official transfers will rise sharply on a one-time basis in connection with contributions in support of coalition efforts in the Persian Gulf. Thus, the current account surplus may well increase marginally from its $35.8 billion level of 1990.

Developments in 1992 should reflect a number of factors. Import growth should gain support from the anticipated acceleration of domestic demand, while exports benefit from the recovery of demand growth in foreign markets. However, given the still substantial gap between imports and exports, a reduction in the Japanese trade surplus will require total imports to grow at least 25 percent faster than total exports. Due in part to the inevitable uncertainty about price developments in 1992, it is an open question whether this differential will obtain. Changes in the invisibles account are expected to normalize after this year's unusual developments: a continued increase in investment income earnings balanced against further growth in tourism outflows. Overall, a moderate nominal increase in the Japanese current account surplus is anticipated; in terms of GNP it may move slightly above the 1-1/2 percent mark.

External account developments in **Germany** will continue to be strongly affected by the structural shifts in trade arising from unification as well as some important developments in official transfers. On the trade side, imports will reflect domestic demand growth which should remain solid (albeit less strong than the unusual surge in 1990), as well as the incremental import need associated with restructuring in the former GDR. Exports are likely to be limited by both weaker growth elsewhere in Europe as well as the trade diverting effects of unification. In addition, trade trends in the former East Germany (included in the balance of payments accounts since 1990) will have an important impact. The Eastern states registered a large surplus in 1990 as imports collapsed (due to a switch in sourcing to the FRG) while exports remained fairly steady. This year, however, "east" German exports to the CMEA countries are expected to fall dramatically due to the introduction of trade on a hard currency basis. Finally, the invisibles deficit will be boosted this year by Persian Gulf support, as well as assistance for the USSR and debt relief for Eastern Europe. In aggregate, the German current account surplus is expected to decline substantially this year to under 1 percent of GNP (versus almost 3 percent in 1990).

Determinants of trade account developments in 1992 are expected to include: the anticipated revival of foreign demand growth in 1992 (especially among Germany's major European trading partners); a partial fading of Germany's unification-related import surge; and, the assumed absence of any special developments in oil prices or exchange rates. On the current account, investment income growth will be balanced against the continuation of transfers at relatively high levels. Thus, Germany's trade and current account adjustment is likely to slow in 1992, and may well reverse.

The **United Kingdom** is forecast to record trade and current account deficits in 1991-1992 that are appreciably lower than those recorded in the 1988-1990 period. The pronounced weakness of U.K. demand this year, coupled with the relative strength of demand abroad, should both support British export growth and compress import growth. However, this adjustment impulse is expected to lose some force in 1992 with the narrowing of the cyclical divergence between the U.K. and key trading partners. Given the linkage of the pound to the European Exchange Rate Mechanism, the U.K.'s relative inflation performance will have important implications for its competitiveness in future years; current inflation differentials would imply a loss of British competitiveness in import-competing and export sectors. Thus, the British trade and current account deficits are forecast to decline substantially this year in both nominal terms and as a percent of GNP, but then increase again slightly in 1992.

The relatively small current account deficit in **France** is expected to change little this year but decline in 1992 due in large part to cyclical factors and the relatively solid competitive position of French exports. Prospects for improvement of trade and current account deficits in **Italy** remain constrained by relatively high unit labor cost increases. Nevertheless, with Italian demand slowing relative to some of its key trading partners, modest declines in both deficits in 1991 and 1992 cannot be ruled out.

The **smaller industrial countries** are not expected to register any dramatic external account shifts in the 1991-92 period; the aggregate current account deficit of the group is forecast to remain at around the $30 billion level of 1990. **Spain** will continue to have the single largest deficit, followed by **Australia**. Both **Sweden** and **Finland** have turned in substantially higher deficits recently, the product of both higher oil prices and relatively strong domestic demand growth; in neither case is a quick turnaround seen as likely. Natural gas exports have protected the **Netherlands** from the oil price shock, while exports have been buoyed by German demand; as a result, the Dutch current account surplus has strengthened, and should expand further, given slowing domestic absorption.

C. Policy Directions

As a general matter, the industrial countries continue to follow a fiscal policy course directed to improving the strength and balance of the public finances over the medium term. Discretionary policies remain generally geared toward expenditure restraint, the loss of momentum of the current expansion notwithstanding. Fiscal restraint is seen increasingly as an essential complement to a monetary policy approach geared especially toward price stability and the preservation of national competitiveness over the longer term.

The immediate situation in **Germany** is obviously very different, reflecting as it does the compelling and unanticipated requirements associated with unification. Years of successful fiscal consolidation cut the general government budget from a deficit of 3.7 percent of GNP in 1982 to a surplus of 0.2 percent of GNP in 1989. However, heavy unification-related costs, coupled with long-planned tax relief, overwhelmed additional growth-generated revenue in 1990 and boosted the deficit sharply to about 2.1 percent of GNP. A combined federal, state and municipal government deficit (all-Germany) of about DM 140 billion (or about 5 percent of GNP) has been officially targeted for 1991, and additional tax measures were recently taken to achieve this objective. There are good prospects for declining deficits over the medium term, but continued large borrowing needs can nevertheless reliably be anticipated.

Budget surpluses in **Japan** continued to grow in 1990, the product of growth-driven revenue gains as well as a cautious approach on the expenditure side. Between 1983 and 1990 the general government budget moved from a deficit equivalent to 3.6 percent of GNP to a surplus equivalent to an estimated 2.8 percent of GNP. The central government budget deficit (excluding the large social security surplus) fell to a low level in 1990.

Projections for Non-Industrial Countries

Economic prospects for the less developed countries continue to differ significantly along regional lines. As a group, however, the LDCs are expected to show modestly better output growth this year, accelerating to a higher level in 1992. The aggregate LDC current account deficit is forecast to widen substantially in 1991 and 1992 due mainly to reconstruction and oil price effects in the Middle East and growing deficits in Eastern Europe.

The **Asian** NIEs are likely to continue as the LDC growth leaders, remaining on a path of steady 6 percent aggregate growth driven less by exports than during the 1980s. Most countries in the region will benefit from the assumed stability of oil prices at around their pre-war level as well as, in 1992, the forecast growth acceleration in the industrial countries. Other Asian economies should also benefit from the (at least partial) restoration of interrupted worker remittance flows from the Gulf region.

Import volume growth that remains in excess of export volume growth is forecast to contribute to a further reduction in the current account surplus of the NIEs this year. However, a portion of this correction may be reversed in 1992 as strengthening growth in trading partner countries narrows somewhat the cyclical differential between the NIEs and the Industrial countries.

Aggregate growth in **Latin America** is expected to improve after last year's contraction as the benefits of market-oriented stabilization programs begin to emerge. With effective implementation of these measures, inflation could be substantially reduced and real GNP growth restored to the 3 percent level in 1992. For a number of countries, the adoption of comprehensive adjustment measures has cleared the way for significant debt reduction agreements and promoted private capital inflows and a return of flight capital.

Latin America's aggregate current account deficit is expected to narrow slightly in 1991-92 relative to the higher level of 1990. While the earnings of oil producing countries will decline, those of other commodity exporters should improve, and recovery in North America should support better export performance.

Economic prospects for the **Middle East** remain highly uncertain in light of continued political unrest and the regional effects of the U.N. mandated economic sanctions against Iraq. With numerous countries likely to recover only slowly from direct war damage and the disruption of important commercial ties, the regional economy as a whole is expected to contract somewhat further this year. However, growth prospects for 1992 would appear substantially better given the expectation of reconstruction activity, renewed oil production in some countries, and restoration of some traditional commercial links.

Reconstruction demands, resumed growth, and relative oil price stability will, however, put pressure on external accounts. Thus, after registering a roughly $12 billion surplus in 1990, the aggregate Middle East current account position is likely to move back into deficit this year and next.

Growth in **Africa** was limited last year in part by negative terms of trade effects (higher oil prices coupled with lower prices for important commodity exports) as well as the slowdown in world trade growth. Positive elements of the picture for 1991 and 1992 are the assumed stability of oil prices, demand recovery outside the region, and a possible modest recovery in non-fuel commodity prices. Overall output growth is therefore expected to pick up moderately to the 3 to 4 percent range through 1992.

The current account improvement recorded for Africa as a whole in 1990 was due in large measure to earnings gains by oil exporters. Market developments assumed for this year and next, however, will reverse much of this improvement through negative terms of trade effects, in addition to the negative effect of slower world trade growth.

The countries of **Eastern Europe** are in a state of fundamental economic and political transition and will remain so for many years. Far-reaching institutional and structural changes are being implemented against the background of a vulnerable economic situation characterized by large underlying imbalances, both domestic and external. Together with substantial revisions in basic data for these economies, this makes the near-term forecasting challenge more than usually difficult. For most of Eastern Europe, output is likely to continue to contract this year, though at a much slower pace than in 1990. Contributing factors are expected to be: the transition to hard currency trade arrangements; financial restraint to combat inflation pressures; and, the ongoing shake-out in the manufacturing sector. Pursuit of appropriate policies will help arrest the downturn and contribute to a moderate output recovery in 1992.

A further increase in the combined current account deficit of the Eastern European countries in 1991-92 seems virtually assured. Key elements will be the fact that hard currency imports are being substituted for internal CMEA trade flows in manufactured goods, and the renegotiation of oil trade arrangements with the USSR guarantees a higher oil bill even at current world prices.

PART IV: POLICY ISSUES

The industrial countries will continue to pursue economic policies to achieve two fundamental objectives: (1) to ensure sustained output growth in the industrial countries in an environment of low inflation; and, (2) to promote the continued growth of international trade, sustainable external imbalances, and the smooth functioning of the international financial system.

The current economic situation presents the major industrial countries with both challenges and opportunities. Macroeconomic and structural policy tools need to be employed on a mutually supportive and complementary basis, and in a manner that gives appropriate balance to meeting near-term needs and enhancing the prospects for economic health and stability over the longer run. Such a recovery will be crucial in supporting policy reforms and economic growth and adjustment in Eastern Europe and the developing countries.

On the fiscal side, this implies a generally cautious approach to overall public sector expenditure growth, as well as a commitment to improving the underlying strength of the public finances by eliminating spending of questionable merit. For the monetary authorities, the challenge is to pursue a course that provides adequate scope for near-term investment and growth while at the same time avoiding policies that lead to reignition of inflation. Recent and prospective developments suggest the need for authorities to focus their efforts on ensuring a sound, low-inflation recovery in the industrialized world.

At present for some countries, such as the United States, the United Kingdom and Canada, this means returning to a path of moderate and sustainable growth, along with continued external adjustment. For Japan and the countries of continental Europe, it means ensuring adequate low-inflation growth in 1991 to support global expansion and shared objectives in Eastern Europe and Latin America.

In the structural area, policy efforts need to focus on reducing or eliminating rigidities which impede the effectiveness of traditional macroeconomic policies, distort investment decisions, and prevent efficient competition and resource allocation in goods and services markets, both domestically and internationally.

These broad objectives are discussed and pursued at the annual Economic Summits, ministerial level meetings of the Organization for Economic Cooperation and Development, meetings of the G-7 Finance Ministers and Central Bank Governors, and meetings of the policy-making Interim Committee of the International Monetary Fund.

These bodies serve, in varying degrees, as focal points for the international policy consultation and coordination process, whose principal purpose is to translate these general objectives into specific policy actions that reflect the unique circumstances of the individual countries. The coordination process is therefore both systematic and flexible, and over the years its scope has evolved to reflect changing economic realities.

Prospects for long-term success in these areas will be enhanced by the successful conclusion of the Uruguay Round of trade negotiations. Strengthening and expanding the scope of GATT disciplines would constitute a structural improvement of enormous importance, offering potentially major gains in the efficiency of global trade.

The need for appropriate and forward-looking policies does not end with the industrial countries. The developing countries also have major responsibilities for their own long-term economic growth and development, and for strengthening the international system upon which all countries depend. There is no substitute for open, market-oriented approach to regulatory and structural issues, and sound and balanced fiscal and monetary policies. Excessive public intervention should be eliminated; prices, interest rates, and exchange rates should be determined by market forces; investment policies should encourage a return of flight capital and greater engagement of foreign investors; and trade policies should focus on increasing domestic integration with the global economy. In particular, full developing country participation in and adherence to Uruguay Round agreements is essential.

Over the past decade, real progress has been made in a number of important areas: in the growth and inflation performance of the industrial economies; in the understanding of international economic and financial linkages; in developing effective, coordinated responses to complex international economic problems; and, in the growing, worldwide recognition that outward-looking, market-oriented policies offer the best prospects for prosperity. Today's challenge is to extend these achievements and make further progress on the problems that still remain.

PART V: IMPACT OF TRADE BARRIERS

The Congress requires the reporting of foreign barriers to U.S. trade in the National Trade Estimate Report on Foreign Trade Barriers, as revised by Section 1304 of the Omnibus Trade and Competitiveness Act of 1988. The law also requires quantification, where feasible, of the estimated effects of individual barriers to U.S. exports of goods and services and on U.S. foreign direct investment. This National Trade Estimate Report was sent to the Congress on March 29, 1991. For a listing of foreign trade barriers and their impact on U.S. trade and investment, the Congress is referred to the National Trade Estimate Report.

There are, however, certain fundamental observations which can be made regarding the impact of foreign trade barriers on U.S. trade. Trade barriers can and do have substantial impact on exports, imports, production and trade balances for specific product areas and, to a lesser extent, for specific U.S. bilateral trade relations. However, trade barriers may have little impact on the aggregate imbalance in U.S. trade in the long run. Macroeconomic factors play the major role in determining trade balances.

Summing the estimated effects of individual trade barriers would overestimate the impact of the elimination of foreign trade barriers on the U.S. trade balance. The "partial equilibrium" framework in which trade barrier effects are usually estimated, in fact, precludes the drawing of any derivative implications of specific trade barriers for the aggregate trade balance.

Trade barriers have particular economic importance because they introduce microeconomic inefficiencies (resource misallocation) in production and impose real costs on the nation. They impair productivity and restrict the growth in real incomes. However, their effect on aggregate trade balances or the projection of aggregate trade balances is limited.